

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Phil Phillips on June 1, 2006

DATED: August 11, 2006

On Thursday, June 1, 2006, David Callaghan of Kroll and Sharon Blaskey and Brian Faerstein of Willkie Farr & Gallagher LLP ("Willkie") interviewed Phil Phillips on behalf of the Audit Committee. Mr. Phillips was not represented by counsel. The interview was conducted telephonically and lasted approximately two hours.

The following memorandum reflects my thoughts, impressions, and opinions regarding our discussion with Mr. Phillips, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Mr. Callaghan began the interview by explaining the circumstances and purpose of the City of San Diego's (the "City") creation of the Audit Committee, noting that information obtained during the course of the interview would be used, if relevant, in our analysis of the issues and would be reflected in an Audit Committee report. Mr. Callaghan stressed the importance of Mr. Phillips being honest, accurate and complete in his answers, and informed Mr. Phillips that if he is unclear about any question, he should ask Mr. Callaghan or Ms. Blaskey to clarify. Mr. Callaghan asked Mr. Phillips to treat the matters discussed during the course of the interview as confidential and not share the information with others.

Ms. Blaskey added that though Willkie does not represent Mr. Phillips, we would be treating the communication of information during the interview as confidential until the ultimate release of the Audit Committee's Report, after which it seems likely that any privilege attaching to our interview memoranda will be lost. Ms. Blaskey stated that the attorney-client privilege does not apply to Mr. Phillips, though the memorandum is, for the time being, protected by the work product privilege. Moreover, the Audit Committee retains the right to disclose information from the interview both in its report and to the SEC, the U.S. Attorney's Office or KPMG as requested. Ms. Blaskey reiterated the importance to Mr. Phillips of ensuring that his answers were accurate and truthful, emphasizing that he clarify any issue that he believed needed further explanation.

At the end of the interview, Mr. Phillips inquired whether he could receive either a transcript of the interview or notes prepared in connection with the interview. Ms. Blaskey explained that we would not be sharing either our notes or summary memorandum of the

interview. She explained that the summary we would be creating would not be a transcript of the interview but rather our own record of what transpired.

Background

Mr. Phillips received an accounting degree from San Diego State in 1970 and started working for the City in 1972. Mr. Phillips commenced work as a junior accountant with the Model Services program, which was a federal grant program, and held that position for approximately one and one-half years. Mr. Phillips subsequently transferred to the City Auditor and Comptroller's Office (the "A&C"), starting work in that Office as a junior accountant in the Capital Improvements program. His immediate supervisor in that position was the Principal Accountant of the Capital Improvements Program. Mr. Phillips then transferred to the Accounting Operations section for approximately six months, working on revenue expenditure projections. At that point, Mr. Phillips was promoted to Principal Accountant in the Intergovernmental Agencies section and reported directly to the Accounting Division Manager. Shortly after Ed Ryan starting working for the City and became City Auditor and Comptroller in 1982, Mr. Phillips was promoted to Accounting Division Manager, reporting directly to Ryan. Mr. Phillips retired in May 2004.

As the Accounting Division Manager, Mr. Phillips oversaw the four sections of the Accounting Division of the A&C: Accounting Operations; Intergovernmental Agencies; Proprietary/Enterprise; and Capital Projects. Mr. Phillips served in a mostly supervisory role, assisting the principal accountants of the four sections with complex issues as they arose. Specifically, if there was a problem that could not be solved within a particular section, the issue was brought to his attention and he would use resources available him to resolve the problem. For example, if the Accounting Operations section was having difficulty with a budget issue, he would work with the Principal Accountant and accounting staff of that section to seek a resolution to the problem. Mr. Phillips explained that the principal accountants were independently responsible for their sections and he did not consistently interact with them. When Mr. Phillips retired from his post in 2004, the four principal accountants were: Rudy Graciano (Accounting Operations); Maria Weston (Intergovernmental Agencies); Ed Wochaski (Proprietary/Enterprise); and Tracy McCraner (Capital Projects). Mr. Phillips also worked on special capital improvement projects, contributed in the budget control process, and worked hand-in-hand with the Audit Division Manager in making personnel decisions for the A&C.

Pension Issues

Mr. Callaghan asked Mr. Phillips about his general awareness of pension-related issues during his time as Accounting Division Manager. Mr. Phillips explained that most of his knowledge about the pension system came from reading the newspapers, but he did not have an understanding of the specific issues involved. Mr. Callaghan asked Mr. Phillips when he first became aware of the Manager's Proposal in 1996 ("MP-1"). Mr. Phillips believed that he generally learned about the ramp-up scheme of MP-1 in 1996, understanding that the City would eventually make payments in the future to make the system "whole." Mr. Phillips was not involved in the budget process in connection with the proposal.

Ms. Blaskey asked Mr. Phillips what his involvement with pension issues would have been in 1995 and 1996. Mr. Phillips responded that he would have had virtually no

involvement at that time, as Ryan and Terri Webster (Assistant Auditor and Comptroller) were the key "decision-makers" and there were several accountants who dealt specifically with pension-related issues (Cecilia San Pedro and Mike Phillips). San Pedro and Mike Phillips reported directly to Ryan and Webster regarding these issues rather than going through Mr. Phillips as an intermediary. Ms. Blaskey asked Mr. Phillips to clarify what he meant by "decision-makers." Mr. Phillips explained that "decision-makers" was a poor use of terminology, clarifying that Ryan and Webster dealt with major policy decisions such as pension funding whereas accountants -- presumably including himself -- were not involved in such matters. Ms. Blaskey asked whether Mr. Phillips ever had policy discussions with Ryan or Webster, to which Mr. Phillips responded that he did not. Mr. Phillips could only recall that Ryan had added language to the annual appropriations ordinance regarding pension issues. Asked whether he had a role in this process, Mr. Phillips explained that he likely worked with the City Attorney's Office and the Financial Management Department in drafting the language for the ordinance. Mr. Phillips recalled that he would have only been involved prior to this step if there were particular issues with which he was familiar, such as special project funds (*e.g.*, storm drain fund, convention center fund). In connection with this role, he would have consulted with staff members for different sections of the ordinance.

Ms. Blaskey asked Mr. Phillips if he recalled any specific instances of his assisting with the drafting of pension-related language. Mr. Phillips could only vaguely recollect helping in this process, as the drafting of the ordinance was just part of the regular course of business for the Accounting Division. Ms. Blaskey inquired about what types of pension information would go into the appropriations ordinance. Mr. Phillips could not specifically recall, though he noted that, in reference to the specific instance that he previously mentioned, he believed that Ryan had added some contingency language toward the end of the ordinance. Ryan had worked with Les Girard (Deputy City Attorney) on that language. Mr. Phillips did not understand what the language was in reference to nor could he recall understanding at the time. Ms. Blaskey inquired about Mr. Phillips's interactions with Ryan and Girard. Mr. Phillips explained that Ryan had discussed the wording of the ordinance with Girard and then asked Mr. Phillips to put the language in it. Mr. Phillips then clarified that he does not believe that any of the language in the ordinance was ultimately implemented and finalized. He stated that City Council did not take any action on the particular item in the ordinance. Ms. Blaskey asked Mr. Phillips why the language stood out in his mind, inquiring specifically whether he had had any concerns about the accuracy of the language. Mr. Phillips could not posit a particular reason it stood out, noting that he was not an expert in pension issues and just had to rely on Ryan and Girard for the information. He did not have a specific instinct that the language was wrong.

Ms. Blaskey later read from a handwritten note dated February 17, 1998, apparently written by Webster to "Mike ____" and "Phil ____" (Exhibit 1), asking Mr. Phillips if the "Phil ____" referred to him. Mr. Phillips remarked that he had seen this document before during a prior interview and did not remember receiving it while he worked for the City. He explained that he could not understand why he would have received it, as he never interacted with Rick Roeder (SDCERS actuary) on any issues (the note discusses an approach to take on a conference call with Roeder regarding the pension system's Net Pension Obligation).

Ed Ryan

Mr. Callaghan asked Mr. Phillips whether Ryan was difficult to work with. In connection with this question, Mr. Callaghan read from an April 21, 2003 email (Exhibit 2) Mr. Phillips had written to Webster in which Mr. Phillips voiced concerns about Ryan's "intimidating management style" and indicated he would be reporting Ryan to Employee Assistance. Mr. Phillips explained that he found it uncomfortable to work with Ryan, describing Ryan as a micromanager who was "rather threatening" and sometimes "verbally and emotionally abusive." Mr. Callaghan inquired as to how this affected Mr. Phillips's ability to work with Ryan or caused him to second-guess certain decisions, in particular omissions of information from documents. Mr. Phillips explained that Ryan never pushed him very far about these issues, but that he could not be sure if the same could be said for other staff members. Asked later whether he ever reported Ryan to Employee Assistance, Mr. Phillips said that he never did, though he thought about doing so many times during 2003. With regard to Webster, Mr. Phillips was disappointed that she did not support him more often regarding his complaints about Ryan's interactions with staff members, though he did not interact with her on a regular basis. Based on the A&C hierarchy, Mr. Phillips reported to Ryan, and the principal accountants managing each of the sections in the Accounting Division reported to Mr. Phillips. Though Webster was officially Ryan's second-in-command, Mr. Phillips rarely had to report to her, though she would sometimes solicit information from him.

Mr. Phillips explained that he never felt compelled to do things he believed were inappropriate; rather, his questions as to Ryan's decisions mostly involved matters of efficiency and hiring practices. Mr. Callaghan later asked Mr. Phillips to expand on his perception of Ryan as pushy and threatening. As an example, Mr. Phillips explained that Ryan was a stickler for getting the financial statements out on time. When the A&C was falling behind schedule one year, Ryan became verbally abusive to the audit manager (Tom Saiz) of the independent auditing firm that was auditing the financial statements, demanding that Saiz expedite the process.

Mr. Callaghan later inquired about Ryan's interactions with Paul Webber (the City's outside bond counsel). In particular, Mr. Callaghan referred to the description of "pissing contests" between the two men in a summary written by V&E of its interview with Mr. Phillips (Exhibit 3). Mr. Phillips explained that he did not like that word choice, and he did not observe many of the meetings between Ryan and Webber but did recall that, during one at which he was present, there was a general "head-butting" between the men. He recalled feeling uncomfortable during the meeting, as he had hoped it would be a problem-solving session. Mr. Callaghan asked Mr. Phillips whether there was a give-and-take between Ryan and Webber on a regular basis regarding disclosure issues. Mr. Phillips reiterated that he did not observe many of these meetings but was not reassured by the one that he did observe. He explained that this particular meeting pertained to the general audit arising out of Diann Shipione's allegations. Mr. Phillips recalled that Ryan, Webster, Girard, Webber and Dan Deaton (outside disclosure counsel) were at this meeting and they worked on the wording in the City's voluntary disclosure that was released in January 2004. He explained that this was a difficult process, as many new errors were discovered in the process of drafting the disclosure.

Budget Issues

Mr. Callaghan asked Mr. Phillips whether he and Ryan philosophically differed as to how accounting was handled in the A&C. Mr. Phillips explained that they may have disagreed slightly as to accounting issues, but more of their differences pertained to budget issues. Mr. Callaghan asked whether Ryan ever over- or under-budgeted certain items. Mr. Phillips explained that Ryan often worked with the City Manager on budget issues and sometimes would use revenues that were “questionable.” Asked what he meant by “questionable,” Mr. Phillips explained that revenues would sometimes be over- or under-stated in the budget and other times certain expenditures would not be accounted for at all. As an example of this practice, Mr. Phillips explained that police officer and firefighter overtime pay would not be accounted for in the budget process, so the budget was often inaccurate from the outset.

Ms. Blaskey asked Mr. Phillips whether there were any other costs not accounted for in the annual budget. Mr. Phillips stated that land fill fees and other fringe benefits (such as unemployment and worker’s compensation) were not sufficiently accounted for, explaining that the Auditor’s Office would not see the background information on these costs until too late in the budget review process. Mr. Phillips clarified that the expected fringe benefit payments of a particular department were calculated as a set percentage of that department’s projected expenditures for any given year. The amount of fringe benefits was not broken down into the different elements for each department and did not show up in the budget. Mr. Phillips believed it would have been a better practice to monitor the different costs during the year, as more often than not the funds set aside for fringe benefits were insufficient.

Mr. Callaghan asked Mr. Phillips whether the A&C ever manipulated the budget to achieve a balanced budget. Mr. Phillips explained that he and other staff in the office may have had information about revenues that were rather speculative in nature but that were nonetheless counted toward the budget. Mr. Phillips noted that he and Graciano were not directly involved in these decisions, which were mostly handled by Ryan, the City Manager and the City Council.

Accounting Issues

Ms. Blaskey inquired whether Mr. Phillips could recall any instances when staff members of the A&C felt uncomfortable about particular accounting decisions that were made by Ryan. Mr. Phillips recalled the issue regarding “accrual,” noting that he did not learn the full story about this issue until after he left the A&C in 2004. Mr. Phillips explained that Ryan wanted to be “conservative” on the accrual of sales tax, which “goes all over the place.” In particular, Ryan decided not to recognize the accrual of \$10 million of sales tax as revenue when closing out the books on FY 2002, instead rolling it forward to the following fiscal year when the funds would actually be received.

After he left the A&C, Mr. Phillips learned that Graciano felt uncomfortable about this decision -- presumably because the implementation of GASB 34 required this revenue source to be accrued when recognized. Mr. Phillips clarified that he did “not remember the facts the same way Graciano did” (about how the decision not to conform the accrual of sales tax to the requirements of GASB 34 was made). Specifically, Mr. Phillips did not recall being

involved in a meeting with Graciano and Ryan regarding this issue, as Graciano had stated during one of his interviews with V&E.

Ms. Blaskey asked Mr. Phillips whether he believed the non-accrual of the \$10 million was appropriate. Mr. Phillips believed it was a conservative approach but not necessarily inappropriate, as these types of adjustments had been made for years. Mr. Phillips noted that he did not review these calculations on a yearly basis and he did not get involved in reviewing this and related issues until errors were discovered in the FY 2002 financial statements in 2003. Ms. Blaskey asked Mr. Phillips what his understanding of this issue was in the present. Mr. Phillips explained that, based on what Graciano has stated, he believes Ryan understood that there was a potential large amount of revenue that had not been accrued and could be carried forward.

Ms. Blaskey inquired whether this was the type of accounting question that would have been brought to Mr. Phillips's attention in his supervisory role. Acknowledging that this was a good question, Mr. Phillips surmised that, though Graciano would often raise significant issues to Mr. Phillips, this issue was not brought to his attention because the A&C was very busy at the time and Mr. Phillips was on his way out. Moreover, Mr. Phillips explained that accountants in the A&C would often bring issues directly to Ryan's attention rather than using Mr. Phillips as an intermediary, particularly when it came to issues with the Proprietary section.

Ms. Blaskey asked Mr. Phillips whether he could recall times that Graciano did discuss concerns with him. Mr. Phillips explained that Graciano spoke with him most often about budget issues and issues that were out of their control that caused frustration throughout the year. Mr. Phillips believed that Graciano just came to him to vent and did not necessarily expect him to take action on most issues. Mr. Phillips explained that he would meet with Graciano everyday in the context of daily meetings with Ryan and the other principal accountants. Generally, Mr. Phillips believed that everyone in upper management was up to speed about things going on with each other's accounts.

CAFR Preparation

Asked about his involvement in the process of producing the City's Comprehensive Annual Financial Report ("CAFR"), Mr. Phillips stated that he was likely considered the "expert on financial statements" in the A&C. However, Mr. Phillips noted that he did not have comprehensive knowledge of specific GASB standards and guidance. Up until 2001, Mr. Phillips explained that he reviewed the financial statement portion of the CAFR but did not review the footnotes, which were prepared by the City's outside auditors with information solicited from various City departments and offices. Mr. Phillips explained that his role changed slightly sometime around 2001 or 2002.

Ms. Blaskey asked Mr. Phillips to explain the process by which the CAFR is produced on a yearly basis. Mr. Phillips explained that the overall process of compiling information contained in the CAFR's financial statements was managed by the Accounting Operations section of the Accounting Division of the A&C (headed by Graciano and, prior to Graciano's tenure, Bob Wilson). Each accountant in the Accounting Division was responsible for a certain number of City funds or area of operations and would prepare information for their specific fields. The Accounting Operations section would compile all of this information and roll it up into a central document that would later be formatted into the CAFR's financial

statements section. Mr. Phillips later explained that Graciano would not personally compile all of this information, as each individual accountant inputted the relevant information for his particular portion of the financial statements. The Accounting Operations section would take the fully-inputted document and organize it in the correct CAFR format and then send it off to the printer.

With regard to preparation of the footnotes section of the CAFR, Ms. Blaskey asked Mr. Phillips what he believed Graciano did in terms of communicating with the outside auditor. Mr. Phillips explained that the outside auditor would have a weekly meeting with staff members of the A&C and provide questions and issues that it had. Mr. Phillips stated that if "things were not getting resolved," the issue would go to Graciano to consider. Asked whether Graciano had a procedure to ensure that the outside auditor's questions and concerns were satisfied, Mr. Phillips did not know. He surmised that Graciano's staff would have likely been in charge of actually responding to the outside auditor, though one would have to ask Graciano about this process.

Mr. Callaghan asked Mr. Phillips about the review process of the footnotes after the Accounting Operations section finished working with the outside auditor. Mr. Phillips explained that he would do a review of the consolidated portions of the CAFR for "reasonableness," examining both the financial statements section and the footnotes section. Mr. Callaghan inquired whether Ryan or Webster reviewed the CAFR as a whole. Mr. Phillips recalled that Ryan was given a copy of the CAFR before it was finalized. Asked what the City's last step was in the CAFR preparation process, Mr. Phillips had some difficulty answering this question, noting only that the CAFR would not be published until the letter of the City's outside auditor arrived. Mr. Callaghan asked where the ultimate responsibility for the preparation and accuracy of the CAFR lay in the City. Mr. Phillips again had difficulty answering this question, and was unable to describe precisely the City's review process of the CAFR. Asked whether the outside auditor had the ultimate responsibility for the contents of the CAFR, Mr. Phillips said that it did not. Mr. Callaghan inquired further as to who was ultimately responsible for the CAFR at the City, asking if Ryan did an additional review at the end of the process. Mr. Phillips could not recall what Ryan would have done with regard to reviewing the CAFR, conceding in the end that the "City felt the responsibility fell on the outside auditors."

Ms. Blaskey later asked Mr. Phillips who in the A&C reviewed the footnotes after the outside auditor completed them and returned them to the City. Mr. Phillips was not sure, though he surmised that Graciano would likely have coordinated the review and that Ryan also received a copy of the completed footnotes. Mr. Phillips believed that Ryan "occasionally" read them, as he would sometimes ask Graciano (or Wilson, before Graciano's tenure as Accounting Operations director) questions about the footnotes. Asked whether Webster was also given a copy of the footnotes, Mr. Phillips did not know. Ms. Blaskey asked Mr. Phillips whether Ryan and Webster would have been the only officials in the A&C who could have identified errors in the pension footnote of the CAFR. Mr. Phillips generally agreed with this assessment, adding that the accountant in charge of pension issues (San Pedro) would also have been capable of identifying pension-related errors.

Toward the end of the interview, Mr. Phillips returned to the issue of where ultimate responsibility lay for the accurate preparation of the CAFR. He explained that he believed staff in the A&C and other City employees fulfilled their roles in most respects. Even

though mistakes were made, Mr. Phillips still felt that the City was taking responsibility for those mistakes. He explained that there were a lot of aspects of the CAFR review process and everyone believed that they were doing an appropriate job. Mr. Callaghan agreed that faulty organization may have contributed to the problems with the financial statements, but emphasized that somebody in the City's management has to ultimately be held responsible for the failures. Mr. Phillips conceded that "in terms of structure, there was no final responsibility." Mr. Phillips explained that there have been some changes to create an independent auditing unit that is not engrossed in the CAFR preparation process such that it cannot conduct a truly objective review of the document.

Enterprise Funds

Ms. Blaskey asked Mr. Phillips how information about enterprise funds were wrapped up into the CAFR. Mr. Phillips explained that a separate portion of the financial statements section of the CAFR was dedicated to the City's enterprise funds. Ms. Blaskey asked whether a liability in the sewer or water fund would be reflected in the CAFR, to which Mr. Phillips responded that it would. Asked what effect such a liability could have on the City's General Fund, Mr. Phillips said that he did not know but suspected that it would not have an impact on an accounting basis. He mentioned that the City Attorney would know if such a liability had a legal effect on the General Fund.

Bond Offerings

Mr. Callaghan asked Mr. Phillips about his involvement with City bond offerings. Mr. Phillips explained that he contributed to the decision of how proceeds from an offering would be allocated in the applicable project (e.g., whether a construction fund or a reserve fund would be created to house the proceeds of the offering). He was not involved in the disclosure aspects of an offering.

Tax Anticipation Notes

Mr. Callaghan asked Mr. Phillips how Tax Anticipation Notes Series ("TANS") offerings were conducted. Mr. Phillips explained that Webster did most of the work on TANS offerings, working closely with Holly Reed-Falk and Financing Services. Mr. Phillips recalled that he may have been involved with reviewing cash-flow issues in connection with these offerings, but he was not involved in discussions about disclosure issues.

Asked about the purpose of these offerings, Mr. Phillips explained that they were issued toward the beginning of the fiscal year (around June or July) so that the City could obtain a lump-sum of funding upfront that it would pay off with tax proceeds received later in the year. Thus, TANS functioned to turn receivables into cash with a short-term repayment schedule. The amount of an issuance depended on revenue projections for the upcoming fiscal year. Webster worked with Graciano and Reed-Falk in making these projections. Asked whether these were public offerings, Mr. Phillips stated that he believed they were.

Bond Rating Agencies

Mr. Phillips stated that he did not participate in the preparation for presentations to rating agencies.

Interactions with Other City Offices

Mr. Callaghan asked Mr. Phillips about his interactions with other City departments, officials and outside professionals, in particular relating to City accounting or disclosure issues. Mr. Phillips could not recollect any such interactions. He did not interact with elected officials. He only interacted with outside professionals during informal lunch meetings once or twice a year.

FY 2002 CAFR Review Process

Mr. Callaghan asked whether Mr. Phillips was aware of the allegations made by Diann Shipione about illegalities and irregularities in the administration of the City's pension system. Mr. Phillips recalled that he was aware she raised concerns but that he was not familiar with them "verbatim." He was aware of her allegations before he left the City in 2004 because her concerns regarding the FY 2002 CAFR in 2003 had led to the review process in 2003 and 2004.

Mr. Callaghan asked Mr. Phillips about his involvement in the investigation and review process. Mr. Phillips explained that there was an extensive team assembled, consisting of officials from both the Accounting Division and Audit Division of the A&C and the City's outside auditor (Caporicci & Larson at the time). The Audit Division, led by Darlene Morrow-Truver, coordinated the review of the pension footnote, the issue upon which Shipione had focused most of her allegations. Mr. Phillips recalled that Morrow-Truver's main assistants in this process were Jeanne Cole, Nicole Miller and Judy Zellers. San Pedro, an Accountant IV in the Accounting Division who was primarily responsible for the pension footnote, also assisted in this review. Asked what type of work was done with regard to this footnote, Mr. Phillips explained that the team looked at all aspects of the footnote.

With regard to his involvement in the review process, Mr. Phillips explained that he did some "spot-checking" between different years' financial statements, looking for isolated inconsistencies. Ms. Blaskey inquired about the basic approach to and organization of the review process. Mr. Phillips stated that he was largely on the outside of the process so he was not familiar with the specifics, but he thought that there were several teams organized in a multi-tiered hierarchy of review. Mr. Phillips clarified that he was "kind of on the outside doing [his] own review." Asked why he took this particular approach, Mr. Phillips could not remember but believed that this approach evolved as more and more errors were discovered.

Ms. Blaskey asked Mr. Phillips about his reaction to the errors. He stated that he was surprised and disappointed. He later added that he was surprised at the "degree of the errors being discovered," such that he could empathize with Webber's frustration about the disclosure issues. Asked whether he could recall what caused the errors, Mr. Phillips explained that at some points he believed that one could pinpoint the source of the errors to a small group of people but at other times it seemed like the mistakes derived from bad information from other

City departments and offices. Ms. Blaskey inquired whether the mistakes were a product of a lack of coordination. Mr. Phillips did not know, stating that he believed the people who worked on the CAFR were intelligent. He posited that the accuracy of the CAFR could have been compromised by pressure from above to get things done quickly. Mr. Phillips stated that he did not think insufficient training was necessarily a reason for the errors; rather, he believed that numbers and statements were just not double-checked properly. Further, he believed that it was a multi-layered problem, as other City departments were understaffed such that those officials were likely also burnt out to some extent.

Ms. Blaskey asked Mr. Phillips whether there was anything in particular that he was looking for in the financial statements when he conducted his review. Mr. Phillips explained that he focused primarily on whether significant issues stood out, comparing the financial statements to the previous year's with an eye toward identifying major discrepancies. Ms. Blaskey inquired whether it was through this process that Mr. Phillips identified the sales tax accrual error. Mr. Phillips stated that he did not think so; rather, he believed that he discovered the significance of this error while going through the projections for the 2004 budget. Ms. Blaskey asked when this budget projection process took place. Mr. Phillips posited that it must have been in the fall of 2003 when he was reviewing the current year's budget for future projections.

Ms. Blaskey asked Mr. Phillips what he did when he discovered the sales tax accrual error. Mr. Phillips recalled that he brought the error to Graciano's attention. Ms. Blaskey inquired whether this was the same accrual error that Graciano referred to, stating Ryan had told him not to change it (the error for which, according to Graciano, was the result of a conscious decision not to correctly implement it, and which was no error at all). Mr. Phillips answered that it was. Asked what Graciano's reaction was when Mr. Phillips brought the improper accounting treatment to his attention, Mr. Phillips recalled that Graciano was somewhat frustrated that Mr. Phillips was bringing up the issue. Ms. Blaskey asked whether Mr. Phillips left the issue with Graciano or took it upon himself to resolve it. Mr. Phillips could not recall but believed that he may have met jointly with Graciano and Webster at some point to discuss the issue. Mr. Phillips believed that Webster ultimately spoke with Lisa Irvine (Deputy City Manager) and that the error was ultimately corrected. Mr. Phillips clarified that he later learned that it was an "accounting gimmick," by which Mr. Phillips was apparently referring to the original act of not accruing the sales tax revenue, and not the actual correction of the error. Mr. Phillips noted that making projections is an inherently speculative process but that this particular instance crossed the line of mere speculation. He reiterated that he was not aware of anything being done incorrectly until he saw the calculation was wrong during the budget projection process, but even at that point he was not aware that Ryan had "twisted anyone's arm" to make the calculation wrong in the first place. Since he was not included in the discussion regarding the decision to not account for the expected sales tax revenue, Mr. Phillips stated that he did not know why Ryan would have made this decision. He was surprised Ryan had made the decision given the size of the error.

Blue Ribbon Committee Report

Mr. Callaghan asked Mr. Phillips if he assisted in the preparation of the Blue Ribbon Committee Report on City Finances. Mr. Phillips said that Webster was the liaison to the Blue Ribbon Committee from the A&C. While she may have solicited some information from Mr. Phillips in connection with the investigation, he did not have a substantive role in preparing the Report.

Wastewater

Ms. Blaskey asked Mr. Phillips whether he was aware of how the City set its sewer user rate structure. Mr. Phillips said that he was generally aware but was not "in the loop" on this issue, even less than he was on retirement issues. Ms. Blaskey asked whether Mr. Phillips was aware of an issue of noncompliance with certain requirements while he was working for the City. Mr. Phillips recalled that City Council would often review the rates, but he was not aware of any of the noncompliance issues that are currently being discussed in the media while he served the City.

WF&G